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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Section 272(b)(1)'s "Operate Independently" Requirement for Section 272 Affiliates	**WC Docket No. 03-228**

Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp

December 10, 2003

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ECONOMICS AND TECHNOLOGY, INC

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DECLARATION OF LEE L SELWYN

Qualifications and Assignment

Lee L Selwyn, of lawful age, declares and says as follows:

1 My name is Lee L. Selwyn, I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108 ETI is a research and consulting firm specializing in telecommunications and public utility regulation and public policy. My Statement of Qualifications is annexed hereto as Attachment 1 and is made a part hereof. I have been asked by AT&T to review the *Notice of Proposed Rulemaking* ("NPRM" or "Notice") issued by the Commission in the above-captioned proceeding, to analyze the issues and questions raised therein, and to provide the Commission with specific recommendations thereon.

2 I have participated in proceedings before the Federal Communications Commission ("FCC" or "Commission") dating back to 1967 and have appeared as an expert witness in hundreds of state proceedings before more than forty state public utility commissions. I have participated in numerous regulatory proceedings involving public utility affiliate relationships and inter-affiliate transactions and transfers These have included merger proceedings before the California PUC involving Pacific Telesis Group and SBC, and Bell Atlantic and GTE, before the Illinois Commerce Commission involving SBC and Ameritech, before the Connecticut Department of Public Utility Control involving SBC and SNET, and before the Maine PUC involving NYNEX and Bell Atlantic I also participated in written comments filed with the FCC regarding both the SBC/Ameritech and Bell Atlantic/GTE merger applications. I have participated in a number of Section 271 proceedings, including those in Pennsylvania, New Jersey, California, Minnesota, Delaware and Virginia I have also submitted testimony before several state commissions addressing proposals for structural separation of ILEC wholesale and retail operations I participated in proceedings before the California PUC involving Pacific Bell's reorganization of its Information Services (primarily voice mail) business into a separate subsidiary, and the spin-off of Pacific Telesis Group's wireless services business into a separate company I have participated in a number of matters involving the treatment of transfers of yellow pages publishing from the ILEC to a separate directory publishing affiliate, including the recent case before the Washington Utilities and Transportation Commission addressing imputation of (then) US WEST yellow pages revenues

3 I have participated in proceedings related to issues raised by the instant NPRM. I submitted declarations on behalf of AT&T in the Section 272 Sunset proceedings, and several *ex parte* declarations and presentations in the Verizon OI&M Forbearance proceeding.[1] As the Commission notes in its NPRM, the discrimination and cost issues raised in those proceedings similar to those in the *Verizon OI&M Forbearance Proceeding*, and other petitions for forbearance filed by other BOCs. I understand that AT&T will be submitting my prior declarations into the record in this proceeding.

Summary

4. It has long been understood both by Congress and the FCC that where an ILEC is engaged in the provision of regulated monopoly and nonregulated competitive services, it has a powerful incentive to pursue strategies that work to advance its competitive operations to the disadvantage of its regulated monopoly services This can be accomplished through outright discrimination in the provisioning of essential services, favoring the ILEC's competitive operations (whether provided on an integrated basis or through a separate affiliate) to the detriment of

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1 *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Reply Declaration of Dr. Lee L Selwyn on behalf of AT&T, August 26, 2002, ("*Selwyn Sunset Reply Declaration*") subsequently filed in *Petition for Forbearance From The Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53 203(a)(2) Of The Commission's Rules*, CC Docket No. 96-149, ("*Verizon OI&M Forbearance Proceeding*") attached to the Comments of AT&T, September 9, 2002. I have also participated in the preparation of ex parte presentations in the *Verizon OI&M Forbearance Proceeding*, filed November 15, 2002, July 9, 2003, July 29, 2003, September 9, 2003, September 16, 2003

competitors, and/or through an overallocation of joint costs to monopoly services, in effect forcing the ILEC's monopoly services to cross-subsidize its competitive line of business

5 In 1996, the Commission determined that these dangers of anticompetitive abuses were especially significant in two areas First, discrimination and cost misallocation were very likely if the BOC and its separate long distance affiliate created pursuant to Section 272 were permitted to perform operating, installation, and maintenance ("OI&M") services on each other's facilities. Second, the BOCs and the Section 272 affiliate would likely misallocate costs and discriminate against rivals if they were permitted to jointly own switching and transmission facilities, as well as the land and buildings housing those facilities

6 The Commission is now considering whether to eliminate these rules Because the risk of anticompetitive abuses is just as strong today as it was in 1996, the Commission should retain its rules and continue to require OI&M and facilities ownership separation In this declaration, I explain several ways in which the BOCs' ability to misallocate costs and to discriminate will be significantly enhanced if the rules are not retained

7 First, joint ownership of switching and transmission facilities, currently forbidden by the *Non-Accounting Safeguards Order*, would allow a BOC to simply ignore many of the statutory requirements of Section 272 To the extent that a switching or transmission facility is jointly owned by a BOC and its affiliate, the Section 272 affiliate would not be required to contract with the BOC for those services There would be no terms, conditions or rates that could be compared

to the terms, conditions or rates available to competing carriers. In addition, joint ownership of the land upon which switching and transmission facilities are located would serve to both decrease competitor access to collocation space and ensure that the Section 272 affiliate obtains preferential access to space in a BOC central office

8. Second, the difficulties that have been encountered by the Commission and affected parties in detecting — let alone remedying — misallocation of operating costs incurred for the joint benefit of the BOC ILEC and Section 272 affiliate will be compounded exponentially if the two entities are allowed to jointly own and utilize equipment and facilities in common Part 64 of the Commission's Rules provides some guidance as to how the costs of plant used to provide both regulated and nonregulated services are to be allocated between these two categories However, Part 64 is inadequate to ensure that the costs of a facility are appropriately allocated between regulated and nonregulated uses Were the BOC and its affiliate allowed to engage in joint ownership, a BOC could acquire new plant solely or primarily for the purpose of supporting the competitive (nonregulated) service while managing to assign and to recover a portion thereof (perhaps even most) from regulated basic monopoly services Such misallocations would be, for all practical purposes, largely undetectable and, in all probability, non-auditable as well

9 Third, if OI&M integration is permitted and the BOC ILECs are allowed to provide OI&M services to their Section 272 affiliates, they will be able to misallocate costs by taking advantage of an important loophole in the Commission's rules. Specifically, Verizon has stated that it will charge its Section 272 affiliate for such services using the "prevailing company price"

method[2] The use of so-called "prevailing company price" assumes (improperly in this case) that whatever internal transfer price is being charged by the Verizon BOC for OI&M services represents the fair market value "arm's length" price that is contemplated by Section 272(b)(5). However, the true market value of these services is the price that Verizon and other BOCs would be required to pay to nonaffiliated providers for these services, or the costs that they would incur if the OI&M functions were undertaken internally on a stand-alone basis. If the Commission eliminates its ban on joint OI&M, Verizon and the other BOCs will be able to misallocate OI&M costs by setting the transfer price at "prevailing company price" below that level, rather than at the actual market value *to the Section 272 affiliate* of the OI&M services

10 Finally, nothing regarding Section 272(b)(1) has changed since the Commission first applied the operations, installation, and maintenance and joint ownership rules in 1996 The BOCs still have significant incentives and ability to cost-shift and discriminate against rivals through jointly provided services and joint ownership of facilities The current rules successfully mitigate the effect of these incentives by removing OI&M services from available joint services, and by banning joint ownership of switching and transmission facilities. No alternative competitive safeguards will be wholly effective in preventing the BOCs from engaging in anticompetitive and discriminatory conduct.

2 *Verizon OI&M Forbearance Proceeding*, Ex Parte filing of Verizon, August 11, 2003, at 4.

The BOCs' strong incentive to discriminate against rivals in the long distance market through cost misallocation and discrimination — a concern that formed the basis for the OI&M separation requirement and the joint ownership prohibition — has not changed since 1996.

11 In the instant NPRM, the Commission seeks comment as to whether the elimination of the prohibition on joint ownership of equipment and facilities and on the sharing of OI&M functions reduces the BOCs' incentive or ability to discriminate against unaffiliated rivals in the long distance market. By engaging in cost misallocation and by pursuing such discriminatory tactics with respect to the provisioning of essential network services to rival carriers, the BOCs gain significant competitive advantage As the Commission concluded in 1996, sharing of OI&M functions would "create the opportunity for such substantial integration of operating functions so as to preclude independent operation and would inevitably afford the affiliate access to the BOC's facilities that is superior to that granted to the affiliate's competitors."[3] The Commission reached a similar conclusion with respect to joint ownership of switching and transmission facilities

12 The intervening years have not changed the fact that, without substantial new regulations and burdensome regulatory oversight, the BOCs continue to derive enormous competitive benefit from cost misallocation and discriminatory practices. As I have previously noted on several occasions in testimony submitted before the Commission, the BOCs maintain a virtual

3 *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as amended*, CC Docket No 96-149, First Report and Order and Further Notice of Proposed Rulemaking, 11 FCC Rcd 21905, 21984, at para 163 (1996) ("*Non-Accounting Safeguards Order*")

monopoly with respect to basic local residential exchange service, and control the facilities necessary for CLEC provision of mass market residential and small business services as well as "enterprise" services furnished to larger business customers.[4] Insofar as the BOCs' captive local customer base confronts significantly less competition than exists in the long distance market, the BOCs have powerful financial and competitive incentives to shift costs from competitive long distance over to monopoly local services, access services, and UNEs

13 Incentives to misallocate costs have not been mitigated by price caps.[5] Although the BOCs have often argued that price cap plans remove the incentives to engage in cost-shifting, the reality of state price cap plans (recently recognized by state regulators participating in the Federal-State Joint Conference on Accounting Issues[6] ("Joint Conference") belie such claims BOCs frequently ask for and receive adjustments to their price caps based upon cost and revenue data, and the ability to inflate costs or depress revenues is essential to the appearance of fiscal

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4 *Selwyn Sunset Reply Declaration*, at paras 14-18, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64 1903 of the Commission's Rules*, CC Docket No 00-175 ("*Dominant/Nondominant Proceeding*"), Declaration of Lee L. Selwyn on behalf of AT&T, June 30, 2003 ("*Selwyn Dominant/Nondominant Declaration*"), at p 7-22

5 A more in-depth discussion of the effect of changes in state price cap plans and CALLS on the BOC's ongoing incentive to misallocate costs can be found in *Selwyn Dominant/Nondominant Declaration*, at p 93-98, *Dominant/Nondominant Proceeding*, Reply Declaration of Lee L Selwyn on behalf of AT&T, July 28, 2003, at paras. 6, 57, 58, 65.

6 *Federal-State Joint Conference on Accounting Issues*, WC Docket 02-269, *Letter from the Joint Conference to the Commission*, October 9, 2003.

necessity This reality was recently recognized by Commissioners Martin and Copps, as well as by numerous state regulators, as demonstrated by the Letter transmitting the recommendations of the Joint Conference:

> By under-pricing services or assets, the ILEC would be absorbing some of the cost and thereby lowering the affiliates's overall cost structure, to the overall benefit of the ILEC's holding company Additionally, ILECs could use this new discretion to offset higher-than-desired earnings at the regulated entity. This would be an advantageous strategy whenever an ILEC believes it would benefit from making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement [7]

14 There has been no change in the BOCs' incentives to misallocate costs or discriminate against IXC competitors since the 1996 *Non-Accounting Safeguards Order* The conclusions drawn in the *Non-Accounting Safeguards Order* and the *Accounting Safeguards Order* in 1996 are the same conclusions drawn by the US Supreme Court and the Joint Conference in 2003.[8] As a result, the Commission must consider the effect of any prospective OI&M and joint ownership rule changes upon

(1) the *ability* of the BOCs to engage in cost-shifting; and

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7 *Id*., at 24

8 The U S Supreme Court noted that, "price caps do not eliminate gamesmanship " *Verizon v FCC*, 535 U S. at 512

(2) the effectiveness of the new safeguards the Commission implements to replace the OI&M and joint ownership restrictions.

Joint ownership of OI&M facilities provides BOCs with numerous undetectable means of misallocating costs and discriminating against rivals.

15. The difficulties that have been encountered by the Commission and affected parties in detecting — let alone remedying — misallocation of operating costs incurred for the joint benefit of the BOC ILEC and Section 272 affiliate will be compounded exponentially if the two entities are allowed to jointly own and utilize equipment and facilities in common. The critical question is how will the costs of jointly-owned facilities be allocated between the BOC ILEC and the Section 272 affiliate? One response, proposed by longtime BOC advocate Prof. Alfred Kahn, would in effect give the affiliate a "free ride" on all jointly-used facilities, assigning to it only the *additional* costs attributable to the affiliate's use that would not exist if the facilities were owned and utilized solely by the ILEC. According to Kahn, "[t]he way to achieve the complete transfer of risk from purchasers of existing telephone services to the companies themselves is by a rule that completely removes from the costs on the basis of which the rates for those services are set *all the costs additionally imposed on the company by its undertaking to put itself in a position to offer new services*."[9] The "free ride," of course, is wholly at odds with the Section 272(b)(5) "arm's length" requirement, since it's difficult to imagine any situation in which a company

9. Alfred Kahn, *How to Treat the Costs of Shared Voice and Video Networks in a Post-Regulatory Age*, Policy Analysis, No. 264 (Nov. 27, 1996) at 6, emphasis supplied.

would give an unrelated firm a "free ride" with respect to the latter's use of the former's facilities and services

16 Part 64 of the Commission's Rules provides some guidance as to how the costs of plant used to provide both regulated and nonregulated services are to be allocated between these two categories However, Part 64 provides for something roughly akin to fully distributed cost, which gives little or no effect to the *purpose* for which specific costs have been incurred, and clearly does not embrace or reflect the "arm's length" requirement of Section 272(b)(5)

> 47 CFR §64.901(b)(4) The allocation of central office equipment and outside plant investment costs between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment during the calendar year when nonregulated usage is greatest in comparison to regulated usage during the three calendar years beginning with the calendar year during which the investment usage forecast is filed

What this allocation concept ignores is the *purpose* for which the equipment or facilities were acquired -- i e., the extent to which the plant acquisition decision was driven by regulated vs. nonregulated services Additionally, by limiting the relative use measure to "the three calendar years beginning with the calendar year during which the investment usage forecast is filed," the resulting allocation is almost guaranteed to overassign costs to the core regulated service and underassign costs to the nonregulated category

17 Suppose, for example, that there are 10,000 subscriber loops in a particular community all being served entirely by copper feeder and distribution plant, and that all of these are being

used solely to provide regulated Plain Old Telephone Service ("POTS"). Now, suppose that the ILEC decides to replace the copper feeder and distribution facilities with fiber at a cost of $10-million (i.e., $1,000 per subscriber) so as to be able to offer DS-3 broadband service to each home, a service which, for purposes of this example, we can assume will be nonregulated. No plant replacement would be required simply to continue offering only POTS, so in that sense the *entirety* of the $10-million capital outlay is being driven by the nonregulated broadband service. However, once the fiber is in place and the $10-million has been expended, all services to the community — *POTS and broadband* — will be provided over the fiber. Now, suppose that only 5% of the households being served by this new fiber distribution plant initially order the broadband service, and that an additional 5% order broadband each year for a total of ten years, at which time 50% of the customers will be taking broadband. §64.901(b)(4) only requires that relative usage over a three-year time frame be used to apportion the costs of this facility. At the end of the first three years, 15% of the new facilities will be used to provide broadband services (i.e., a gain of 5% per year for each of the first three years); hence, when the new facilities first go into service, at least 85% of the cost will be assigned to POTS because, after the first three years, only 15% of the households will be ordering broadband. Even with respect to the 15% of households that subscribe to broadband, some portion of the cost will also be assigned to POTS, since those same customers will presumably also be taking POTS from the ILEC. If we assume that the cost is allocated 50/50 between POTS and broadband for the 15% of the households that take both, then fully 92.5% of the $10-million investment cost will be assigned to POTS, leaving only 7.5% assigned to the nonregulated broadband service. During the successive years of the 10-year ramp-up, additional shares of the joint cost of this common plant will be assigned to nonregulated service, but until the assignment is made, all other investment-related costs — depreciation, cost of money, maintenance, etc — will remain in the regulated service category Of course, since the *entirety* of the $10-million investment was driven by broadband, *any* assignment of *any* portion of that capital outlay to POTS operates to force POTS customers to cross-subsidize the BOC's broadband deployment

18 Dr Kahn's "free ride" approach may be somewhat better than the allocation contemplated by §64 901(b)(4), since (presumably) the entire $10-million investment (and associated depreciation, cost of money, maintenance and other costs) would be considered an "*additional cost*" of the nonregulated broadband service and thus be assigned to that category However, that would still leave 100% of all other joint costs, such as supporting structures (poles and conduit), assigned to regulated basic service, since the new fiber optic cables could be accommodated without any additional structure cost Yet in an arm's length transaction, the (theoretically unaffiliated) nonregulated service provider would obviously be charged for the use of those facilities as well, even if the ILEC incurred no additional costs to provide for such additional use.

19 It does not take significant imagination to see how joint ownership would enable a BOC to acquire new plant solely or primarily for the purpose of supporting the competitive (non-regulated) service while managing to assign and to recover a portion thereof (perhaps even most) from regulated basic monopoly services Such misallocations would be, for all practical purposes, largely undetectable and, in all probability, unauditable as well, unless the Commission is prepared to involve itself in reviewing the "business case" underlying each individual plant

acquisition decision. If the *effect* of joint ownership of facilities is to shift costs to regulated services and/or to permit nonregulated services to use jointly-owned facilities without paying their fair share (based upon fair market value), the result is a *de facto* cross-subsidy of the BOC's competitive operations by its regulated monopoly services And that is expressly and unambiguously prohibited by 47 CFR §64.901(c) "A telecommunications carrier may not use services that are not competitive to subsidize services subject to competition"

Joint facilities ownership will render ineffective numerous Section 272 safeguards that cannot be replaced.

20 In addition to raising cost allocation problems, joint ownership of switching and transmission equipment would make the enforcement of other requirements of Section 272 impossible Sections 272(c)(1) and (e) require a Section 272 affiliate to obtain services and facilities on the same rates, terms, and conditions available to unaffiliated entities, and the Commission has noted that:

> [these] nondiscrimination safeguards would offer little protection if a BOC and its section 272 affiliate were permitted to own transmission and switching facilities jointly To the extent that a section 272 affiliate jointly owned transmission and switching facilities with a BOC, the affiliate would not have to contract with the BOC to obtain such facilities, thereby precluding a comparison of the terms of transactions between a BOC and a section 272 affiliate with the terms of transactions between a BOC and a competitor of the section 272 affiliate Together, the prohibition on joint ownership of facilities and the nondiscrimination requirements should ensure that competitors can obtain access to transmission and switching facilities equivalent to that which section 272 affiliates receive [10]

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10 *Non-Accounting Safeguards Order*, 14 FCC Rcd 21983

21 Likewise, it would be impossible for jointly owned facilities to satisfy the nondiscrimination requirements The *Non-Accounting Safeguards Order* specifically cited the potential effect of joint ownership on discriminatory access to facilities

> Moreover, the ban on joint ownership of facilities should protect local exchange competitors that request physical collocation by ensuring that a BOC's section 272 affiliate does not obtain preferential access to the limited available space in the BOC's central office.[11]

If, for example, a portion of the strands in a fiber optic cable are owned by the 272 affiliate and the rest by the BOC, the Section 272 affiliate would have its own "back door" access to the BOC"s central office, and would not need to obtain a dark fiber UNE. Where a competitor requires the same access, it would be required to lease dark fiber from the BOC at tariff prices, assuming that the BOC had dark fiber capacity available. The 272 affiliate would have what amounted to outright ownership of what would normally be considered a BOC's dark fiber. Given these inconsistent requirements of Section 272 and joint ownership, there are no potential safeguards other than maintaining the outright ban on joint ownership of facilities that will support the Commission's other Section 272 requirements

11 *Id* (footnotes omitted)

Without extensive regulatory controls, current BOC plans for sharing of OI&M services would result in significant cost-shifting from competitive to monopoly services.

22 Recognizing the incentives outlined above, the Commission's 1996 solution to forestall cost-shifting was to preclude joint OI&M services and joint ownership of switching and transmission The Commission determined that

> . allowing the sharing of such services would require "excessive, costly and burdensome regulatory involvement in the operation, plans and day-to-day activities of the carrier . to audit and monitor the accounting plans necessary for such sharing to take place "[12]

If the Commission now wishes to remove the OI&M sharing and joint ownership restrictions, extensive regulatory involvement would become necessary to address the same concerns. Even then, extensive regulatory involvement would not be an effective substitute for structural separation, and any benefits of such extensive regulation would be outweighed by its costs.

Detailed regulatory review and more stringent enforcement of BOC-affiliate transactions pursuant to the arm's length requirement of Section 272(b)(5) would be a costly and ultimately inadequate substitute for the existing rules.

23 Section 272(b)(5) requires that the separate affiliate "shall conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection " The concept of an "arm's

12 *Non-Accounting Safeguards Order*, 11 FCC Rcd 21984, at para 163

length" relationship implies that each of the interacting entities are acting solely in their own self-interest *Black's Law Dictionary* defines an "arm's length transaction" as follows:

> **Arm's length transaction.** Said of a transaction negotiated by unrelated parties, each acting in his or her own self interest, the basis for a fair market value determination A transaction in good faith in the ordinary course of business by parties with independent interests Commonly applied in areas of taxation when there are dealings between related corporations, e g. parent and subsidiary. Inecto, Inc. v. Higgins, D C N Y , 21 F Supp 418 The standard under which unrelated parties, each acting in his or her own best interest, would carry out a particular transaction. For example, if a corporation sells property to its sole shareholder for $10,000, in testing whether $10,000 is an "arm's length" price it must be ascertained for how much the corporation could have sold the property to a disinterested third party in a bargained transaction [13]

This definition gives context to the FCC's subsequent Accounting rules designed to enforce this provision As explained in the Accounting Safeguards Order

> The rule we adopt requiring carriers to record all affiliate transactions that are neither tariffed nor subject to prevailing company prices at the higher of cost and estimated fair market value when the carrier is the seller or transferor, and at the lower of cost and estimated fair market value when the carrier is the buyer or transferee --- appears more likely to ensure that the transactions between carriers and their nonregulated affiliates take place on an "arm's length" basis, guarding against cross-subsidization of competitive services by subscribers to regulated telecommunication services [14]

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13 Black, Henry Campbell, *Black's Law Dictionary*, Sixth Edition, 1990, at 109.

14 *In the Matter of Implementation of the Telecommunications Act of 1996 Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket 96-150, *Report and Order*, 11 FCC Rcd 17539, 17607, at para 147 (1996) ("*Accounting Safeguards Order*")

24 The Section 272 requirements create a "code of conduct" governing transactions between a BOC ILEC and its Section 272 Affiliate. Any change in the requirements of Section 272(b)(1) must thus be made within the context of other safeguards that remain in effect, and with an understanding of the limitations of the current applications of those safeguards Section 272(b)(5)'s requirement that the BOCs' Section 272 affiliates must "conduct all transactions" with the BOC on an "arm's length basis with any such transactions reduced to writing and available for public inspection" was intended to safeguard against cost misallocation and cross subsidization In the *Non-Accounting Safeguards Order*, the Commission recognized that, while Section 272(b)(5) presented certain safeguards against cost misallocation, they would by themselves be insufficient to constrain cost misallocation in the joint provision of OI&M services.[15]

25 Considering the existing level of enforcement of Section 272(b)(5), the Commission was absolutely correct in 1996 in finding that Section 272(b)(5) would not constrain the BOCs' ability to afford preferential treatment to their long distance affiliate [16] This past summer — i e , *more than three years after the grant of Section 271 authority is New York* — the Commission finally released a Notice of Apparent Liability arising out of the "biennial" New York Audit proceeding.[17] The Commission identified numerous apparent violations by Verizon

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15 *See*, footnote 3, *supra*

16 *Id*

17 *Verizon Telephone Companies, Inc Apparent Liability for Forfeiture*, File No. EB-03-IH-0245, NAL/Acct. No 200332080014, FRN No. 00089884338, *Notice of Apparent Liability for Foreiture*, Rel September 8, 2003, ("*Verizon Audit Order*")

of the requirements of Section 272, identifying specific cost misallocations amounting to, at cost, some $16-million [18] It is not possible to determine from the New York Audit documents and the Commission's Notice of Apparent Liability if accounting corrections for these violations were ever applied However, in any event, the $283,800 fine imposed by the Commission for these infractions represents 2% of the benefit realized by Verizon from perpetrating these violations. Rather than operate to *deter* such conduct in the future, a fine of this almost inconsequential magnitude actually sends precisely the opposite message to the BOCs, and works to reinforce their strategy of largely — or even entirely — ignoring Congressionally- and Commission-mandated limitations on inter-affiliate transactions.

26 Indeed, the cost misallocation uncovered by the Biennial Audit could have been much worse By removing a portion of potential activities from those permitted to be shared by the BOC and its affiliate (i.e , OI&M services and joint ownership of switching and transmission), the Commission mitigated the effect of the BOC's violations of other Section 272 safeguards If the Commission were now to allow the sharing of OI&M services and the joint ownership of network facilities, it is likely that the magnitude of joint and common costs will increase significantly With this expansion comes the increased risk — and harm — arising from the BOCs' failure to adhere to the requirements of Section 272(b)(5) and to conduct business with their Section 272 affiliates "at arm's length."

18 *Id* , at paras 8-9

27 The New York Audit also uncovered the fact that Verizon had failed to justify its pricing methods as complying with the "arm's length" requirement under the Commission's Section 272(b)(5) rules In explaining the application of Section 272(b)(5) by the *Accounting Safeguards Order* as it applied to Section 272 affiliates, the Commission's Accounting Safeguards Division noted that

> The Commission specifically held that the rules regarding valuation of affiliate transactions in effect at the time, *i e.*, fully distributed cost, *may not be consistent with the section 272(b)(5) requirements for "arm's length basis"* and that the higher of cost or market when the carrier is the seller or transferor, and the lower of cost or market when the carrier is the buyer or transferee was more likely to ensure that the transaction takes place on an arm's length basis [19]

28. The purpose of forcing an affiliate to pay the BOC ILEC the greater of fair market value or fully distributed cost was explained by the Accounting Safeguards Division in 2001, in response to a request by BellSouth to price affiliate transactions at incremental cost:

> This rule was intended to ensure that the captive telephony ratepayer receives the most reasonably advantageous result from the transaction and does not subsidize the LEC's affiliate activities [20]

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19 *BellSouth Telecommunications, Inc Permanent Cost Allocation Manual Petition for Waiver of Section 32 27 of the Commission's Rules*, ASD File No. 01-46, *Order*, Rel. December 17, 2001, at fn 9 Emphasis supplied

20 *Id*, at para 2

Thus, for a BOC to provide a service to its Section 272 affiliate, it must both be able to price the service so as to cover its costs *and* it must charge its affiliate the full fair market value of the service

29 Verizon and other BOCs have exploited a loophole in affiliate pricing to pervert the application of Section 272(b)(5) safeguards and ensure that, contrary to Commission principles, the long distance affiliate, and not the captive local service customers, enjoy the benefit of joint service provision According to documents filed in the Verizon OI&M forbearance proceeding, Verizon intends to price OI&M services provided to its affiliate at fully distributed cost based upon time reporters,[21] where presumably the BOC will bear the majority of the cost for the "joint" service while the Section 272 affiliate will pay only the fully distributed cost of the additional time that a technician spends on the LD portion of the problem

30 Under this scheme, transfer prices are set with no regard for the fair market value of those services, thus working to afford the affiliate all of the benefits of joint activities while bearing little or none of the resulting joint costs Verizon's rationale for this operative violation of Commission rules is the so-called "Prevailing Company Price" loophole The loophole, created by the Commission in 1996, holds that because transactions between Section 272 Affiliates and the BOC ILECs are nominally "generally available" to nonaffiliated parties, the price can be *assumed* to constitute the "fair market value" of the services involved and thus

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21 *Verizon OI&M Forbearance Proceeding*, Ex Parte of Verizon, August 11, 2003, at 3

presumptively "at arm's length."[22] Of course, merely characterizing a service as being "generally available" does not in any sense assure that, *as a practical matter*, nonaffiliated — and competing — firms would actually be able — or willing (for competitive reasons) — to buy the service from the RBOC at the precise terms and conditions at which the inter-affiliate transfer takes place

31 Verizon (and presumably the other BOCs) apparently plan to record charges for OI&M services based upon unit time reporting multiplied by fully distributed cost. Of course, "fully distributed cost" is not how a firm, acting in its own self-interest, would ordinarily set a price for a product or service that it provides to an unrelated entity. The price would instead be based upon the buyer's "willingness to pay," which would itself be driven by the price that the buyer would have to pay to acquire the equivalent product or service from a different supplier, or the cost that it would incur were it to produce the product or service internally. Rather than base the transfer price on what would result from a truly arm's length transaction between unrelated parties, "prevailing company price" in effect defines *any* transfer price that is established by the ILEC as presumptively arm's length! Such a circular result turns the concept of "arm's length" on its head, and renders completely meaningless the affiliate transaction requirements outlined in the *Accounting Safeguards Order*, as well as the Accounting Safeguards Division's Order barring BellSouth from incrementally pricing services provided by the BOC to its Section 272 affiliate Had the Commission intended for *any* price charged by the BOC ILEC to its affiliate to be acceptable under its affiliate transaction rules, it would not have required that the ILEC price

22 *Accounting Safeguards Order*, 11 FCC Rcd 17539, 17601, at para 137.

its services at the higher of fully distributed cost or fair market value, or required that the company engage in a "good faith effort" to estimate a fair market value

32 Properly applied, Section 272(b)(5) accounting requirements would, for any given joint OI&M activity, place the majority of the joint cost on the Section 272 affiliate Were the Section 272 affiliate to self-provision or hire outside contractors for such work, it would incur the full stand-alone cost It is that same "stand-alone cost" that constitutes the "fair market value" of the service being furnished by the regulated entity

33 The fact that BOCs purport to offer to competing IXCs the same services on a "non-discriminatory basis" does not affect their ability or incentive to shift costs First, the BOCs and their affiliates are able to craft contracts that limit the ability of competitors to qualify for the service in question As explained in AT&T's September 30, 2003 *ex parte* submission, BOCs regularly offer services such as billing and collection with special "discounts" applicable primarily to their affiliates.[23] Although some interLATA competitors may qualify for the Affiliate's discounts, unless these competitors purchase significant amounts of the service, the incentive of the BOC will not be affected Second, as the BOCs are aware, a competing IXC purchasing OI&M services from the BOC would provide the BOC with the opportunity to degrade an IXC's interLATA service The Commission previously recognized a BOC's ability to discriminate in favor of its affiliates, and required that, as a condition of Section 271 authority,

23 *Verizon OI&M Forbearance Proceeding*, Ex Parte filing of AT&T Corp., September 30, 2003, at 5-6

a BOC prove that it provides nondiscriminatory service to competing carriers (this requirements was often satisfied by a BOC's performance metrics).[24] If OI&M integration and joint ownership are now to be permitted, the Commission would need to design, establish, implement, monitor, and meticulously enforce similar performance metrics.[25]

The Section 272 affiliates do not now confront, nor have they ever faced, exorbitant OI&M costs as a result of the Section 272(b)(1) requirement.

34 Nothing regarding the BOCs' costs to implement the Operate Independently requirement of Section 272(b)(1) have changed since 1996 Although the Commission notes in the current NPRM that "based on actual experience since gaining section 271 approval, a much more developed record exists today than at the time that the OI&M restriction was adopted to demonstrate the magnitude of the inefficiencies associated with the OI&M restriction," there is

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24 In the Bell Atlantic New York Section 271 Order, the Commission found

> In past orders we have encouraged BOCs to provide performance data in their section 271 applications to demonstrate that they are providing nondiscriminatory access to unbundled network elements to requesting carriers We have concluded that the most probative evidence that a BOC is providing nondiscriminatory access is evidence of actual commercial usage Performance measurements are an especially effective means of providing us with evidence of the quality and timeliness of the access provided by a BOC to requesting carriers.

Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York, CC Docket No 99-295, *Memorandum Opinion and Order*, 15 FCC Rcd 3953, 3974 (1999) at para 53

25 It is not even clear that a permanent set of performance metrics could be created, since the attributes to be monitored may well change as new equipment and facilities are introduced.

nothing new about the cost estimates that have been provided with the BOC petitions for forbearance. As I have explained in my July 9, 2003 *ex parte* filing, Verizon's "cost savings estimates" are without basis and thus significantly exaggerate the potential "savings" from integrated operation.[26] Current estimates such as those presented by Verizon are merely dressed-up versions of the *same* type of claims that had been advanced by the BOCs during the *Non-Accounting Safeguards* proceeding. The Commission rejected such claims then, correctly recognizing that the risks to competition outweighed any credible claims of increased cost.[27] Indeed, the only real source of purported "savings" that would inure to BOC affiliates arises not from efficiencies of joint operations or ownership, *but from the ability that the BOCs would acquire to shift costs out of the affiliate and over to the regulated ILEC entity.*

35. The BOCs could not in 1996, and still cannot, substantiate their claims of the costs of complying with Section 272(b)(1). This lack of evidence has not stopped them from trying, first in the *Non-Accounting Safeguards* Proceeding, then in a *Petition for Reconsideration*, and then in the various *Petitions for Forbearance*, and now in the instant proceeding, to presenting inflated cost estimates in an attempt to remove competitive safeguards.

36. In the *Non-Accounting Safeguards* proceeding, the BOCs had claimed that OI&M requirements would result in costs of the same magnitude as the BOCs now claim here. In 1996,

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26. *Verizon OI&M Forbearance Proceeding*, Ex Parte Declaration of Lee L. Selwyn on behalf of AT&T, July 9, 2003.

27. *See* fn 3, *supra.*

the BOCs attempted to convince this Commission to allow shared OI&M based upon the "crippling" expenses of structural safeguards [28] SBC's initial Comments in the *Non-Accounting Safeguards* proceeding, purportedly drawing upon experience in the voice messaging market, claimed that "[f]or SBC to provide the same service with full structural separation, that is no joint marketing or sharing of administrative services, would increase the voice messaging service cost by 78% and result in an uneconomic business, and the loss of this product to the mass market The result of structural separation was a loss of efficiency and economies of scope that nonstructural safeguards afford" Subsequently, BellSouth cited this SBC cost assessment, submitting that

> simply allowing a BOC affiliate to provide maintenance and installation services for the telephone company and the interLATA company will not lead to integration of services for the telephone company and the interLATA company will not lead to integration of operations. Accordingly, BellSouth agrees with those comments in the proceeding below that the imposition of additional structural separations requirements, particularly regarding installations and maintenance activities would result in a loss of efficiency and economies of scope [29]

Despite years of opportunity, the BOCs have never substantiated these claims with anything more substantive than the undocumented speculations offered in support of the BOCs' OI&M forbearance efforts

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28 USTA Comments (96-149) at 5

29 *Implementation of the Non-Accounting Safeguards of Section 271 and 272 or the Communications Act of 1934, As Amended*, CC Docket 96-149, Petition for Reconsideration filed by BellSouth Corporation, February 20, 1997, at 7, citing SBC Communications Comments (filed August 15, 1996) at 13-17 and USTA Reply Comments (filed August 15, 1996) at 4.

Conclusion

37. The Commission has determined that integration of OI&M functions and joint ownership of equipment and facilities by the BOC ILECs and their Section 272 affiliates created the potential for discrimination, anticompetitive conduct, and the shifting of costs from competitive to monopoly services. Those concerns are as valid today as they were in 1996 when the Commission addressed them in the *Non-Accounting Safeguards Order*. Indeed, as I have shown, existing requirements for allocating costs between regulated and nonregulated services, set out at 47 CFR §64.901(b)(4), will actually *support* the shifting of costs incurred for the benefit of competitive nonregulated services over to regulated monopoly services, since all that the BOC would need to do to accomplish this result is to *use* the newly-acquired equipment and facilities to furnish monopoly services, *whether or not such use is actually required.* While the BOCs have advanced various speculations and undocumented assertions regarding potential cost savings in their forbearance petitions, the potential impact upon regulatory responsibilities and costs, and the risks to nonaffiliated BOC competitors, from OI&M integration and joint ownership also need to be addressed Those costs and risks are substantial, and would easily outweigh whatever "savings" the BOC 272 affiliates might realize For all of these reasons, the prevailing OI&M separation and joint ownership prohibitions should remain in place.

The foregoing statements are true and correct to the best of my knowledge, information and belief

Lee L Selwyn

Statement of Qualifications

LEE L. SELWYN

Dr Lee L. Selwyn has been actively involved in the telecommunications field for more than twenty-five years, and is an internationally recognized authority on telecommunications regulation, economics and public policy Dr. Selwyn founded the firm of Economics and Technology, Inc. in 1972, and has served as its President since that date He received his Ph.D degree from the Alfred P. Sloan School of Management at the Massachusetts Institute of Technology. He also holds a Master of Science degree in Industrial Management from MIT and a Bachelor of Arts degree with honors in Economics from Queens College of the City University of New York.

Dr Selwyn has testified as an expert on rate design, service cost analysis, form of regulation, and other telecommunications policy issues in telecommunications regulatory proceedings before some forty state commissions, the Federal Communications Commission and the Canadian Radio-television and Telecommunications Commission, among others. He has appeared as a witness on behalf of commercial organizations, non-profit institutions, as well as local, state and federal government authorities responsible for telecommunications regulation and consumer advocacy.

He has served or is now serving as a consultant to numerous state utilities commissions including those in Arizona, Minnesota, Kansas, Kentucky, the District of Columbia, Connecticut, California, Delaware, Maine, Massachusetts, New Hampshire, Vermont, New Mexico, Wisconsin and Washington State, the Office of Telecommunications Policy (Executive Office of the President), the National Telecommunications and Information Administration, the Federal Communications Commission, the Canadian Radio-television and Telecommunications Commission, the United Kingdom Office of Telecommunications, and the Secretaria de Comunicaciones y Transportes of the Republic of Mexico He has also served as an advisor on telecommunications regulatory matters to the International Communications Association and the Ad Hoc Telecommunications Users Committee, as well as to a number of major corporate telecommunications users, information services providers, paging and cellular carriers, and specialized access services carriers.

Dr Selwyn has presented testimony as an invited witness before the U S House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance and before the U S Senate Judiciary Committee, on subjects dealing with restructuring and deregulation of portions of the telecommunications industry.

In 1970, he was awarded a Post-Doctoral Research Grant in Public Utility Economics under a program sponsored by the American Telephone and Telegraph Company, to conduct research on the economic effects of telephone rate structures upon the computer time sharing industry. This work was conducted at Harvard University's Program on Technology and Society, where he was appointed as a Research Associate. Dr. Selwyn was also a member of the faculty at the College of Business Administration at Boston University from 1968 until 1973, where he taught courses in economics, finance and management information systems.

Dr. Selwyn has published numerous papers and articles in professional and trade journals on the subject of telecommunications service regulation, cost methodology, rate design and pricing policy. These have included:

> "Taxes, Corporate Financial Policy and Return to Investors"
> *National Tax Journal*, Vol. XX, No 4, December 1967.
>
> "Pricing Telephone Terminal Equipment Under Competition"
> *Public Utilities Fortnightly*, December 8, 1977.
>
> "Deregulation, Competition, and Regulatory Responsibility in the Telecommunications Industry"
> *Presented at the 1979 Rate Symposium on Problems of Regulated Industries - Sponsored by: The American University, Foster Associates, Inc., Missouri Public Service Commission, University of Missouri-Columbia*, Kansas City, MO, February 11 - 14, 1979.
>
> "Sifting Out the Economic Costs of Terminal Equipment Services"
> *Telephone Engineer and Management*, October 15, 1979.
>
> "Usage-Sensitive Pricing" (with G. F. Borton)
> (a three part series)
> *Telephony*, January 7, 28, February 11, 1980.
>
> "Perspectives on Usage-Sensitive Pricing"
> *Public Utilities Fortnightly*, May 7, 1981.
>
> "Diversification, Deregulation, and Increased Uncertainty in the Public Utility Industries"
> *Comments Presented at the Thirteenth Annual Conference of the Institute of Public Utilities*, Williamsburg, VA - December 14 - 16, 1981.
>
> "Local Telephone Pricing: Is There a Better Way?; The Costs of LMS Exceed its Benefits: a Report on Recent U.S. Experience."
> *Proceedings of a Conference held at Montreal, Quebec - Sponsored by Canadian Radio-Television and Telecommunications Commission and The Centre for the Study of Regulated Industries, McGill University*, May 2 - 4, 1984.

"Long-Run Regulation of AT&T: A Key Element of A Competitive Telecommunications Policy"
Telematics, August 1984

"Is Equal Access an Adequate Justification for Removing Restrictions on BOC Diversification?"
Presented at the Institute of Public Utilities Eighteenth Annual Conference, Williamsburg, VA - December 8 - 10, 1986

"Market Power and Competition Under an Equal Access Environment"
Presented at the Sixteenth Annual Conference, "Impact of Deregulation and Market Forces on Public Utilities The Future Role of Regulation"
Institute of Public Utilities, Michigan State University, Williamsburg, VA - December 3 - 5, 1987.

"Contestable Markets: Theory vs Fact"
Presented at the Conference on Current Issues in Telephone Regulations: Dominance and Cost Allocation in Interexchange Markets - Center for Legal and Regulatory Studies Department of Management Science and Information Systems - Graduate School of Business, University of Texas at Austin, October 5, 1987.

"The Sources and Exercise of Market Power in the Market for Interexchange Telecommunications Services"
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"Assessing Market Power and Competition in The Telecommunications Industry Toward an Empirical Foundation for Regulatory Reform"
Federal Communications Law Journal, Vol 40 Num. 2, April 1988.

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Presented at the Twentieth Annual Conference - "New Regulatory Concepts, Issues and Controversies" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1988

"The Sustainability of Competition in Light of New Technologies" (with D. N. Townsend and P D Kravtin)
Presented at the Twentieth Annual Conference - Institute of Public Utilities Michigan State University, Williamsburg, VA, December, 1988.

"Adapting Telecom Regulation to Industry Change· Promoting Development Without Compromising Ratepayer Protection" (with S C Lundquist)
IEEE Communications Magazine, January, 1989

"The Role of Cost Based Pricing of Telecommunications Services in the Age of Technology and Competition"
Presented at National Regulatory Research Institute Conference, Seattle, July 20, 1990.

"A Public Good/Private Good Framework for Identifying POTS Objectives for the Public Switched Network" (with Patricia D. Kravtin and Paul S Keller)
Columbus, Ohio *National Regulatory Research Institute*, September 1991

"Telecommunications Regulation and Infrastructure Development: Alternative Models for the Public/Private Partnership"
Prepared for the Economic Symposium of the International Telecommunications Union Europe Telecom '92 Conference, Budapest, Hungary, October 15, 1992.

"Efficient Infrastructure Development and the Local Telephone Company's Role in Competitive Industry Environment" *Presented at the Twenty-Fourth Annual Conference, Institute of Public Utilities, Graduate School of Business, Michigan State University, "Shifting Boundaries between Regulation and Competition in Telecommunications and Energy"*, Williamsburg, VA, December 1992.

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Presented at Organisation for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, '93 Conference "Defining Performance Indicators for Competitive Telecommunications Markets", Paris, France, February 8-9, 1993.

"Telecommunications Investment and Economic Development: Achieving efficiency and balance among competing public policy and stakeholder interests"
Presented at the 105th Annual Convention and Regulatory Symposium, National Association of Regulatory Utility Commissioners, New York, November 18, 1993.

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Presented at the Organization for Economic Cooperation and Development Workshop on Telecommunication Infrastructure Competition, December 6-7, 1993.

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Where Have All The Numbers Gone? Long-term Area Code Relief Policies and the Need for Short-term Reform, prepared by Economics and Technology, Inc for the Ad Hoc Telecommunications Users Committee, International Communications Association, March 1998, second edition, June 2000

Broken Promises A Review of Bell Atlantic-Pennsylvania's Performance Under Chapter 30, Lee L Selwyn, Sonia N Jorge and Patricia D. Kravtin, Economics and Technology, Inc , June 1998.

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Dr Selwyn has been an invited speaker at numerous seminars and conferences on telecommunications regulation and policy, including meetings and workshops sponsored by the National Telecommunications and Information Administration, the National Association of Regulatory Utility Commissioners, the U S General Services Administration, the Institute of Public Utilities at Michigan State University, the National Regulatory Research Institute at Ohio State University, the Harvard University Program on Information Resources Policy, the Columbia University Institute for Tele-Information, the International Communications Association, the Tele-Communications Association, the Western Conference of Public Service Commissioners, at the New England, Mid-America, Southern and Western regional PUC/PSC conferences, as well as at numerous conferences and workshops sponsored by individual regulatory agencies.